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UNCLAS SECTION 01 OF 02 ZAGREB 000562

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SUBJECT: CROATIAN ENERGY ISSUES

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1. (SBU) SUMMARY: The GoC has initiated a process to produce a comprehensive energy strategy, allegedly as early as this fall. But it appears that at this point there is no consensus on what the country's priorities should be in this sector. In the meantime, considerable attention has centered on proposals to engineer a share swap between Croatia's INA and Hungary's MOL, which would leave the Hungarian firm with considerably greater control over INA. END SUMMARY.

#### A FLURRY OF ACTIVITY REGARDING INA OIL COMPANY

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2. (U) The most immediate issue, and the one receiving the most public attention, is what to do about the future of Croatia's leading oil and gasoline company, INA. Currently, the GoC holds 44 percent of INA's shares, and another seven percent is held by the Croatian Veterans' Fund, while Hungary's MOL oil company holds 22 percent, and the balance is in the hands of institutional investors. According to the terms of the shareholder agreement by which MOL acquired its shares several years ago, MOL could not sell its INA holdings on the market before October 2008. Under Croatian law, the GoC is prohibited from reducing its share to below 25 percent until the day that Croatia joins the EU. On July 5, Croatian PM Sanader and Hungarian PM Gyurcsany announced that they were exploring a possible share swap whereby MOL would acquire 19 percent of INA's shares from the GoC, in return for an equivalently-priced chunk of MOL's stock. The precise ratio at which the shares would be swapped, has been the subject of much speculation, given the influence it would have on INA's overall share prices.

3. (SBU) INA CEO Tomislav Dragicevic told the Ambassador that INA management had not been involved in discussions of the potential swap. He said he had received a call from HANFA (Croatia's SEC equivalent) while he was at a conference in Madrid the day the deal was announced, asking him for details of the proposal, and he had none. Dragicevic and his key advisor Stevo Kulundzic professed to be uncertain what the GoC's strategy was in proposing the swap, but speculated that it was likely related to the impending expiration of restrictions on MOL's current shares in INA. They believed the GoC was nervous about who might buy pieces of INA, and a new swap could mean a new shareholder agreement that would extend the prohibition on MOL selling its current INA stake freely. If that was not the motive, Dragicevic and Kulundzic said, then it was unclear to them what the advantages of the swap would be for Croatia.

4. (U) In the weeks since the Sanader-Gyurcsany announcement, confusion over INA has only increased. Officials at the Veterans' Fund have said they would feel under no obligation either to hold on to their shares or to sell them to MOL, but would seek the greatest financial gain for their own shareholders. Sanader quickly "clarified" his statements by saying that an INA-MOL swap was only "one of the options" that was being investigated. Austria's OMV,

meanwhile, has expressed interest in possibly buying INA shares. When queried by HANFA, OMV said it had no plans at this time for a takeover attempt on INA, but that it was monitoring developments, and hoped that any process would be transparent and give OMV an equal opportunity with MOL.

#### AS OTHER ENERGY POLICIES REMAIN DORMANT

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15. (SBU) While INA's status seems to evolve daily, other energy policies appear to be only crawling forward. The GoC continues to say it is committed to pursuing a liquefied natural gas (LNG) terminal in the northern Adriatic. But selection of the proposed site has been repeatedly put off, even as almost all analysts assume that the site adjacent to the current Omisalj oil terminal on the island of Krk is the only practicable location.

16. (SBU) The government also remains in the process of developing a comprehensive national energy strategy. However, officials of leading energy firms that we have spoken to, such as INA and HEP, the country's primary electrical utility, are skeptical that the strategy will provide any clear vision or guidance. INA's Dragicevic said the small consultancy EKONERG put in charge of the project has suspect qualifications for such a mammoth task. Kulundzic, who is a member of one of the project's advisory bodies, said it appeared to him the strategy would place a heavy emphasis on nuclear power generation, but said he doubted such projects could be economical, given the relatively small size of the Croatian market, with an estimated 3600 megawatts of forecast demand.

17. (SBU) At a dinner hosted by the Ambassador on July 22, Zdravko Muzek of EKONERG said that the strategy was also looking carefully at other power sources such as wind. A HEP executive who was also at the dinner disagreed strongly that wind would provide much of a solution to Croatia's energy requirements.

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18. (SBU) COMMENT: Looming in the background of all of these discussions is Russia. While Croatia meets 30 percent of its oil and 60 percent of its gas requirements domestically, it is keenly concerned about improving its security of supply, and suspicious of Russian actors, who have to date been only bit players in the Croatian energy scene. The lack of consensus about what Croatia's energy development priorities should be, however, has severely hampered efficient or effective planning. The October expiration of MOL's agreement on INA shares may spur a decision on the future of that company. We would like to see some decisiveness on the broader policy issues as well. But in the absence of action-forcing events in relation to other sectors -- whether it be LNG, nuclear or renewables -- we fear that Croatia is likely to see continued dithering on energy. END COMMENT.

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